No. 10214

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

TODD W. JOHNSON,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

Upon Appeal from the District Court of the United States for the Southern District of California, Central Division.

BRIEF FOR THE UNITED STATES.

SAMUEL O. CLARK, JR.,
Assistant Attorney General,

SEWALL KEY,
HELEN R. CARLOSS,
WILLARD H. PEDRICK,
Special Assistants to the Attorney General.

LEO V. SILVERSTEIN,
United States Attorney,

E. H. MITCHELL,
Assistant United States Attorney.

U. S. Post Office and Court House Building, Los Angeles,

Parker & Baird Company, Law Printers, Los Angeles

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Opinion Below.

The only previous opinion in this case is that of the District Court [R. 43-50], reported at 45 F. Supp. 377.

Jurisdiction.

This notice of appeal [R. 67-73] involves federal income tax for the tax year 1935, paid by the taxpayer in 1936 [R. 3, 38]. On April 2, 1940, the taxpayer filed a claim for refund with the Commissioner of Internal Revenue. [R. 84.] The claim was rejected by the Commissioner on September 21, 1940. [R. 7, 21-37.] More than six months after filing this claim for refund the taxpayer instituted an action in the District Court for the Southern District of California for recovery of taxes paid. The judgment of the court denying the claim in part and allowing it in part was entered June 30, 1942. [R. 66-67.] Within three months and on July 13, 1942, the taxpayer filed a notice of appeal in this Court [R. 67-73] pursuant to the provisions of Section 128 (a) of the Judicial Code as amended.

Question Presented.

Whether income received by the taxpayer as his separate property under a settlement agreement preceding divorce is taxable to him in full, under Section 22 (a) of the Revenue Act of 1934, if paid for services rendered prior to execution of the agreement.

Statutes Involved.

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

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SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * * * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that— * * *

* * * * * * * * *

Civil Code of California (1937):

SEC. 158. *Husband and wife may make contracts.* Either husband or wife may enter into any engagement or transaction with the other, or with any other person, respecting property, which either might if unmarried; subject, in transactions between themselves, to the general rules which control the actions of persons occupying the confidential relations with each other, as defined by the title on trusts.

SEC. 159. *Contract altering legal relations: Separation agreement.* A husband and wife cannot, by any contract with each other, alter their legal relations, except as to property, and except that they may agree, in writing, to an immediate separation, and may make provision for the support of either of them and of their children during such separation.

SEC. 161a. *Interests in community property.* The respective interests of the husband and wife in community property during continuance of the marriage relation are present, existing and equal interests under the management and control of the husband as is provided in sections 172 and 172a of the Civil Code. This section shall be construed as defining the respective interests and rights of husband and wife in community property.

Statement.

The facts as stipulated by the parties and found by the District Court may be briefly summarized as follows:

The taxpayer was married in 1921 and resided with his wife in California from 1925 until January 1, 1935, when they separated. [R. 51, 78.] While the spouses were domiciled in California and after July 29, 1927, they accumulated considerable property by virtue of the taxpayer's successful legal practice. When they entered into a formal property settlement agreement on March 4, 1935, in anticipation of divorce, this property was valued at $172,379.41. [R. 51-52, 55.] Included was real estate held in joint tenancy, other real and personal property held as community property, and certain accounts receivable for legal service previously rendered by the taxpayer individually and as a 75 per cent partner in a law firm. [R. 52.] Under the property settlement agreement the assets were roughly divided between the spouses. [R. 52.] Under the agreement the taxpayer took as his separate property, among other items, the entire accounts receivable for the legal service he had previously rendered amounting to some $52,028.85. [R. 17, 44, 58.] In turn he transferred to the wife his interest in certain property, assumed the income tax liability of both parties for the tax years 1934 and 1935, and undertook to pay his wife $500 per month for 12 months. [R. 53, 59.] This settlement agreement, the District Court found, did not constitute reciprocal sales of property by or between the spouses. [R. 53-54.]

The taxpayer reports his income on a cash basis. [R. 61, 69.] The fees for previous legal service rendered by the taxpayer were collected by him in the tax year 1935.

[R. 44.] His income tax return reported only one-half of this income and the other half was reported on his divorced wife's returns. [R. 79, 82-83.] The Commissioner assessed a deficiency against him on the ground that this income as his separate property was taxable to him in full [R. 79-83] and in addition disallowed certain deductions claimed as business expenses. [R. 82.] On the Commissioner's determination that an overpayment had been made on account of the taxpayer's former wife it was agreed that the tax paid for her should be credited to the taxpayer's deficiency and he paid the balance. [R. 83-84.] It was further agreed that in the event the taxpayer was successful in his action for a refund that his recovery should be limited to this balance. [R. 85.]

In addition to these findings, as to which there is no dispute, the District Court made the following findings as prepared by the plaintiff[1] and objected to by the Government:

It found that in making the settlement agreement the parties intended to dispose of and transform their property so that each would thereafter own as his or her separate property a half thereof. [R. 52.] The District Court found that prior to this settlement the wife owned an undivided half interest in community accounts receivable worth one-half thereof and a half interest in other joint and community property worth one-half thereof. [R. 54.] The wife's community half interest in the accounts receivable had no cost basis to her but her half interest in

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[1]These findings were prepared by the taxpayer through a procedural accident although he lost on the major issue presented by the case as plaintiff he won on another—a claim for a deduction for business expenses. As the prevailing party he prepared the findings to support the decision in the case. [R. 51-65.]

other joint and community property had a cost to her of half the total cost, or $65,919.75. [R. 57.]

The court further found that under the settlement agreement the wife disposed of and the husband acquired her half interest in community accounts receivable worth $26,014.23 and her half interest in other joint and community property worth $23,175.48. [R. 58.] The husband on the other hand disposed of and the wife acquired his half interest in certain joint and community property worth $37,000. In addition he assumed the wife's income tax liability for 1934 and 1935 amounting to some $8,201.73, making a total of $45,201.73 acquired by her in the settlement. [R. 59.]

The court found as well that the husband's agreement to pay and his payment of $500 per month for one year was in full satisfaction of the rights, if any, which his wife had to receive support, maintenance or alimony from him.[2] [R. 53.]

In his complaint in the District Court the taxpayer sought a recovery of a portion of the tax paid on two grounds. The first was a claim that he was taxable only

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[2]The Government's objection to these findings [R. 131-140] was based on the proposition that the record would not support findings that the wife's community interest in the accounts receivable and other community property was worth one-half thereof, that the cost of her community interest in such property was one-half of the cost thereof, or that the settlement agreement involved a disposition by the wife of a half interest therein and acquisition by the husband of that interest. The finding that the taxpayer's payment of $500 a month for one year constituted full satisfaction of the husband's duty to support the wife was objected to on the ground that the settlement agreement did not permit that conclusion.

The findings were not amended however. [R. 144-145.]

on one-half of the legal fees in question and the second was the assertion of a right to the deductions disallowed by the Commissioner. [R. 2-11.] The decision of the District Court was adverse on the first claim but favorable to the taxpayer as to the claimed deductions. [R. 43-50.]

From that portion of the District Court decision holding him taxable in full on the compensation for service rendered before but collected after the property settlement agreement the taxpayer has appealed. [R. 67-73.]

Summary of Argument.

As a general rule compensation for personal service is taxable to the one who earned it and controlled its disposition. An exception is made in community property states in that the wife's technical ownership of a one-half interest in the husband's earnings makes that portion taxable to her. In California it is competent for the spouses to transmute community property into separate property. This power extends to past earnings as well as future earnings. If past earnings are converted into the husband's separate property before receipt the exception respecting community income is inapplicable to a taxpayer on a cash basis, who thus receives only separate income and his earnings are taxable to him in full under the general rule. That the earnings were converted into separate property before receipt by virtue of a property settlement preceding divorce entitles the husband to no deduction from his income. Expenditures in connection with the dissolution of marriage constitute personal expenditures and as such are not deductible.

Nor can it be said that the property transferred to the wife on such a settlement constitutes a cost of eliminating her interest in his uncollected earnings, entitling the taxpayer to recoup his expenditures before realizing gain. Prior to the settlement the taxpayer had the legal and factual control of his uncollected earnings so he acquired nothing of substance by the settlement. His transfer of property to the wife was incident to the dissolution of the marriage, not as the cost of anything to be acquired in a capital transaction. The spouses were free under California law to divide the property as they wished. The taxpayer could have transferred to his estranged wife property worth several times his uncollected earnings—it surely would not be argued in such a case that a capital loss could thereby be sustained. The reason why no such loss would be recognized in such a case and the reason why no cost basis for any portion of the taxpayer's earnings can be here recognized is the fact that the property transfer was a part of a marriage settlement rather than a capital transaction. Since his earnings collected by the taxpayer in 1935 were received by him as a separate property they were taxable to him in full. No portion of such earnings was taxable to the wife for she had never enjoyed legal or factual control thereof. Nor did she have any technical ownership of them when received.

Argument.

I.

Under the Law of California the Taxpayer's Earnings Were His Separate Property by Virtue of the Property Settlement and Were Therefore Taxable to Him in Full.

The taxpayer attacks the decision of the District Court holding him taxable in full on fees for service rendered prior to the spouses' property settlement but collected thereafter. In essence he seeks the benefit of the community property system for income received as his separate property after he had formally chosen to abandon the system. The decisions of the Supreme Court and this Court will not permit this.

In *Van Every v. Commissioner,* 108 F. (2d) 650; *Boland v. Commissioner,* 118 F. (2d) 622; *Van Dyke v. Commissioner,* 120 F. (2d) 945; and *Somerville v. Commissioner,* 123 F. (2d) 975, this Court held that earnings received by the husband as his separate property, under a settlement agreement preceding divorce or separation, are taxable to him in full. Those cases are decisive here, as can be shortly demonstrated.

For taxpayers reporting income on the basis of cash receipts the federal income tax on compensation for personal service is assessed, under the general rule, against the person who earned it and controlled its disposition. *Lucas v. Earl,* 281 U. S. 111; *Helvering v. Eubank,* 311 U. S. 122. In the case of earnings in the community property states, an exception to the general rule has been established. The local law vesting in the wife a technical one-half interest in the husband's earnings has been recognized for federal income tax purposes so that half of the community income is taxable to her when paid as such. This privilege of dividing the husband's earnings between the spouses for federal income tax purposes extends only to that income which the local law classifies as community property in which the wife has a vested interest.

United States v. Robbins, 269 U. S. 315.

Under California law the spouses can convert community property into the separate property of one of them. California Civil Code, Sections 158, 159, *supra.* The California cases so holding are collected in an annotation in 120 A. L. R. 264, 265. This power to convert community property into the separate property of the husband extends to compensation earned but not paid as well as to future earnings, contrary to the implication in the taxpayer's brief (pp. 14-17). As this Court stated in *Boland v. Commissioner,* 118 F. (2d) 622, 624:

> Under the law of California (Civil Code Calif., §§158, 159), recognized by this Court (*Van Every v. Commissioner,* 9 Cir., 108 F. 2d 650; *Helvering v. Hickman,* 9 Cir., 70 F. 2d 985; *cf. Black v. Commissioner,* 9 Cir., 114 F. 2d 355, 358), a husband and wife, living in California, may enter into an agreement with each other altering their legal relations as to property and change the character of property from community to separate property, or from separate to community, *theretofore acquired, or thereafter to be acquired.* [Citing several California decisions.] (Italics supplied.)

See also:

Kaltschmidt v. Weber, 145 Cal. 596, 79 Pac. 272;

Wren v. Wren, 100 Cal. 276, 34 Pac. 775.

The effectiveness of the spouses' agreement to convert what would otherwise be community income into separate income was recognized for income tax purposes by this Court in *Van Every v. Commissioner, supra; Boland v. Commissioner, supra;* and *Somerville v. Commissioner, supra.* The fears expressed by the taxpayer at the tax evasion engendered by recognition of power to "retrospectively" convert compensation already earned but not paid into separate income (Br. 16) apply as well to the admitted power in the spouses to alter prospectively the character of compensation neither earned nor paid. If the local law governs as to one it certainly does so as to the other.

As a matter of fact this power, by settlement agreements, to shift the incidence of federal income taxation from one spouse to the other is limited. A taxpayer on a cash basis may not shift the tax to his wife where his compensation has been earned and paid prior to the settlement agreement, for the reason that the tax status of such earnings was fixed on their receipt as community property. *Van Dyke v. Commissioner,* 120 F. (2d) 945, 946 (C. C. A. 9th). But where the agreement precedes the happening of the taxable event (receipt of the income for a taxpayer reporting on a cash basis) the settlement agreement making uncollected income the separate property of one of the spouses does shift the tax burden. *Cf. Poe v. Seaborn,* 282 U. S. 101; *Anderson v. Commissioner,* 78 F. (2d) 635, 639 (C. C. A. 9th). That is the situation in the instant case where the settlement agreement preceded the collection of the earnings in question.

The property settlement agreement executed by the taxpayer and his wife provided that he "shall have as his sole and separate property the following personal property, the title to which stands in his name: * * * His interest in the partnership of Johnson & Johnston, attorneys-at-law; * * * Any fees outstanding for services performed by [him] * * *." [R. 17.] It is clear in light of the foregoing authority that the taxpayer received the compensation in question as his separate property and that his wife had no interest therein. Since he reports his income on a cash basis it follows that, on the happening of the taxable event, his receipt of those earnings, they were includible in full in his gross income for that tax year.

The taxpayer's contention that he is taxable only on one-half of this separate income is thus seen as an attempt to secure a deduction for the property transferred to his wife by the settlement agreement preceding divorce. It is well settled, however, that no deduction can be had for expenditures incurred in connection with dissolution of marriage. Such expenditures are regarded as personal and Congress, for the tax year here involved, made no provision for their deduction from gross income so none can be had.[3] *Gould v. Gould,* 245 U. S. 151; *Ullman v. Commissioner,* 6 B. T. A. 100, 102. This principle is implicit in the decisions of this Court in *Van Every v. Commissioner,* 108 F. (2d) 650; *Boland v. Commissioner,* 118 F. 2d 622, and *Somerville v. Commissioner,* 123 F. (2d) 975. In these cases taxpayers were taxed in full on their separate income without regard to the property transferred to the wife in the settlement agreement preceding separation or divorce which gave their income that status as separate property.

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[3]In the Revenue Act of 1942, Public Law 753, 77th Cong., 2d Sess., Section 120, Congress has changed the law prospectively in some respects by providing that alimony and alimony trust income shall be taxable to the divorced wife and excluded from the husband's gross income.

II.

No Income Tax Can be Levied Against the Wife Whose Community Property Interest in the Husband's Earnings Is Surrendered to Him Prior to His Receipt Thereof.

The taxpayer advances several ingenious arguments designed to by-pass the fundamental principle that payments for settlement of financial obligations incident to marriage are not deductible from gross income. Consideration may first be directed to his assertion that the accrual of the right to income is the taxable event for a taxpayer reporting on a cash basis and that since the earnings in question accrued as community income they must be taxed as such. This assertion ignores the fact that compensation has no status until the moment of the receipt and amounts to an attack on the fundamental and well established distinction between reporting income on an accrual as compared with a cash basis. If the cash basis is used, as it was here, it is the receipt, not the accrual of right to receive, that is the taxable event. *Sivley v. Commissioner,* 75 F. (2d) 916 (C. C. A. 9th). Regulations 94, Article 42-1,[4] issued under the Revenue Act of 1936, so provides as do all its earlier and later counterparts.

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[4]Art. 42-1. *When included in gross income.*—Except as otherwise provided in section 42 in the case of the death of a taxpayer, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. (See articles 41-1 to 41-3.) * * * If no determination of compensation is had until the completion of the services, the amount received is ordinarily income for the taxable year of its determination, if the return is rendered on the accrual basis; or, for the taxable year in which received, if the return is rendered on the receipts and disbursements basis. If a person sues in one year on a pecuniary claim or for property, and money or property is recovered on a judgment therefor in a later year, income is realized in the later year, assuming that the money or property would have been income in the earlier year if then received. * * *

The decisions cited by the taxpayer actually serve to demonstrate that it is the receipt that is the taxable event for a cash-basis taxpayer. *Helvering v. Enright,* 312 U. S. 636, applied the accrual test to income uncollected by a decedent at his death because Section 42 of the Revenue Acts of 1934 and subsequent years expressly authorizes this deviation from the fundamental basis for computing income to a cash-basis taxpayer. If any doubt existed whether accrual of the right or actual receipt is the taxable event for a cash-basis taxpayer this provision adopting the former as to decedents is persuasive that in other cases it is the receipt which is the taxable event. The decisions in *Helvering v. Horst,* 311 U. S. 112; *Helvering v. Eubank,* 311 U. S. 122; and *Harrison v. Schaffner,* 312 U. S. 579, all involve assessments for the period in which the income was paid. Hence they affirmatively support the principle that receipt is the taxable event. These decisions are noteworthy because they make it clear that a taxpayer who has become entitled to receive income, by labor or investment, may receive it for tax purposes on its payment to another at his direction, even by way of gift. Underlying these decisions is the assumption that the taxpayer, by virtue of his labor or investment, has (1) experienced an economic gain and (2) acquired an untrammeled right to receive and (3) to control the disposition of this gain. As stated in *Harrison v. Schaffner, supra* (pp. 581, 582):

> * * * one who is entitled to receive, at a future date, interest or compensation for services and who

> makes a gift of it by an anticipatory assignment, realizes taxable income quite as much as if he had collected the income and paid it over to the object of his bounty. *Helvering v. Horst,* 311 U. S. 112; *Helvering v. Eubank,* 311 U. S. 122. Decision in these cases was rested on the principle that the power to dispose of income is the equivalent of ownership of it and that the exercise of the power to procure its payment to another, whether to pay a debt or to make a gift, is within the reach of the statute taxing income "derived from any source whatever."
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> * * * * * * * * *
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> * * * by the exercise of his power to command the income, he (the taxpayer) enjoys the benefit of the income on which the tax is laid.

The taxpayer's attempt by reference to these decisions to establish that his former wife received one-half the income in question indicates a basic failure to appreciate the principle on which they rest. He argues that under California law accounts receivable for service previously rendered by the husband were community property, that the wife thus owned a half interest therein and that her transfer thereof to the husband in the property settlement should be treated just as the assignment of earnings in the *Eubank* case, *supra,* so as to render her taxable thereon. Assuming *arguendo* that the accounts receivable for service rendered by the husband acquired a status as community property, the question may be asked whether the wife had (1) thereby experienced economic gain (2) whether she had a right to receive the earnings, and (3) whether she had a right to freely dispose of the same.

Without embarking on an exhaustive catalogue of the attributes of California community property and all statutes and decisions relevant thereto it may be observed that the husband's earnings are subject to his exclusive management and control even when received as community property. California Civil Code, Section 172: *Hannah v. Swift,* 61 F. (2d) 307, 310 (C. C. A. 9th); *Grolemund v. Cafferata,* 17 Cal. (2d) 679, 111 Pac. (2d) 641. The wife has no power to dispose of her interest in his community earnings save by relinquishing it to her husband. California Civil Code, Sections 159, 167. He can spend these earnings for current expenses or for any other purpose without accountability then or later to the wife. California Civil Code, Section 172. Prior to and after his death these earnings are subject to claims against him in his individual capacity (*Grolemund v. Cafferata, supra;* California Probate Code, Section 202); and his earnings as community property are not subject to claims of his wife's creditors (*Grace v. Carpenter,* 42 Cal. App. (2d) 301, 108 Pac. (2d) 701). Suits respecting collection and expenditure of these earnings can be instituted by the husband and in his name alone.

> *Johnson v. National Surety Co.,* 118 Cal. App. 227, 5 Pac. (2d) 39, 40.

The wife's only rights respecting the husband's community earnings are (1) protection against their dissipation by gift (but she has no protection against foolish expenditure) (California Civil Code, Section 172), and (2) the right to a half portion on dissolution of the marriage by the husband's death or otherwise while she is still living if anything representing these earnings remains after payment of his debts and the expenses of administration (California Probate Code, Section 201).

Thus it is seen that the wife's interest in California community property prior to dissolution of the marriage is a very technical one,[5] even though characterized as a vested interest. It is clear therefore that acquisition by the husband of accounts receivable for service rendered by him gave rise to no direct economic gain to the wife. She had then no right to receive these earnings or any part thereof and she most certainly had then no right to freely dispose of the same. All of the three prerequisites to application of the *Horst, Eubank* and *Schaffner* cases, *supra,* are therefore absent.

The taxpayer's contention that a settlement agreement is the equivalent of the assignment in the *Eubank* case, *supra,* is also opposed to this Court's decisions in *Van Every v. Commissioner, supra; Boland v. Commissioner, supra; Somerville v. Commissioner, supra;* and *Van Dyke v. Commissioner, supra.* Those cases involved the tax effect of settlements on future earnings. Assignments of future earnings, however, are just as ineffective to shift the incidence of federal income taxation as assignments of past earnings. *Lucas v. Earl,* 281 U. S. 111. This Court correctly held settlement agreements effective

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[5]In *United States v. Goodyear,* 99 F. (2d) 523, 527, this Court stated with respect to community property that:

> We think that theoretically each spouse had possession and enjoyment of his particular interest.

This "possession and enjoyment," vested in the wife on the happening of the taxable event for estate tax purposes (the death of the husband), was held sufficient to prevent inclusion of one-half the community property in his taxable estate. It is noteworthy that the wife there retained her community interest on the happening of the taxable event. It is significant as well that this Court characterized the wife's enjoyment and control of her community interest as "theoretical."

Recognizing the theoretical nature of the wife's community interest, Congress, in Section 402 of the Revenue Act of 1942, Public Law 753, 77th Cong., 2d Sess., provided for inclusion in the decedent's estate of property held with the spouse as community property, except that portion thereof actually contributed by the surviving spouse.

to shift the tax burden because the wife's relinquishment of her community interest in the husband's earnings does not represent the exercise of command over earnings represented when one assigns his earnings, past or future.

The taxpayer's reliance on *Poe v. Seaborn*, 282 U. S. 101, and *United States v. Malcolm*, 282 U. S. 792, for the proposition that prior to receipt of these earnings the wife had control thereof is misplaced, for these cases involved income received as community property and they hold merely that the wife's community interest in such income is a sufficient basis for taxing one-half of it to her. These decisions are unique in recognizing legal title to income as a basis for assessment of the federal income tax. More recent decisions of the Supreme Court, particularly the *Horst*, *Eubank* and *Schaffner* cases, *supra*, and *Helvering v. Clifford*, 309 U. S. 331, emphasize possession of the "normal concept of full ownership",[6] *i. e.*, the right to enjoyment and control of the disposition of income as the basis for identifying the income recipient for tax purposes. The extension of the *Seaborn* and *Malcolm* cases to a situation where the income involved was never received as community property is certainly not warranted by these later Supreme Court decisions. As a matter of fact they clearly indicate the contrary. The husband here earned the income in question, was entitled before the property settlement as well as after to receive it and to freely spend the same. It was paid, after the settlement, as his separate property, so he must therefore be taxed in full thereon.

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[6]This shorthand analysis of the rationale of these decisions is taken from *Bateman v. Commissioner*, 127 F. (2d) 266 (C. C. A. 1st).

III.

No Deduction Can be Had for Property Transferred to the Wife Prior to the Divorce Pursuant to Property Settlement.

As an auxiliary argument to the one just considered the taxpayer contends that he is entitled to subtract from the earnings in question the value of certain property transferred to his wife by the property settlement.

This property transferred, he contends, represents the cost of the earnings. This can only be so if the property was transferred as the purchase price of the wife's interest in his uncollected earnings, *i. e.,* that the settlement agreement was a sale. It is on the theory that it did constitute a sale and on that theory alone that the taxpayer rests his argument for a cost basis for the earnings in question. (Br. 21, 44.)

In direct opposition to this construction of the facts the District Court found that the settlement agreement did not constitute a "sale". [R. 53-54.] Moreover to allow the taxpayer a cost basis for any portion of his earnings would permit the conversion of taxable income to capital without assessment of an income tax. Earnings must be taxed as income before they attain the status of capital. *Bull v. United States,* 295 U. S. 247, 256, 257.

Congress most certainly did not intend that any portion of earnings from personal service should not be taxable as such. Acceptance of the taxpayer's contention that a half of his earnings were received by him as a result of a sale, however, would mean that this half would never be taxed as earnings since the wife, as seen above, is not taxable on the basis of receipt of any of his earnings. This indefensible position results from failure to properly distinguish between capital transactions and personal expenditures.

In order to receive and enjoy his earnings a taxpayer is called on to make many expenditures that are regarded, not as the cost of securing the earnings, but rather as non-deductible personal expenses. Thus expenditures for food, clothing and shelter, while essential to receipt and enjoyment of earnings are not regarded as capital transactions but as personal expenditures. Money expended for support of the family is likewise non-deductible. In this category as well fall expenditures made in connection with divorce.

In both the community property and non-community property states the husband is under a duty to support the wife and his earnings are subject to this obligation. See Vernier, American Family Laws, Vol. III, Sec. 161. If, in a non-community property state, the husband in anticipation of divorce transfers property to his wife, that transfer gives him no basis for a deduction for federal tax income purposes. This is so even though in one sense the property transferred represents the cost of securing freedom from the obligation to support the wife, enabling his full enjoyment of his earnings. Since expenditures in support of the wife are not deductible the taxpayer cannot improve his tax position by merely making such payments in advance in the form of a property settlement. See cases cited in Point I. The true nature of such a transaction is thus a settlement of the marital obligation of support rather than a capital transaction. Is there any basis for treating such a settlement in California differently for federal income tax purposes? The taxpayer argues that there is.

In his brief he contends that "prior to the property settlement, he was never the owner of more than his half of such earnings, which he owned as a member of the marital community" (p. 42), that in order to secure his wife's one-half interest he tranferred certain property to her and hence he should be entitled to deduct the value of the property transferred as the cost of the interest secured from his wife and be taxed only to the extent of the gain thereon.

Basically this argument is simply another aspect of that considered in the preceding point. The fallacy in it is the same—a misconception of the realities of the transaction. As a matter of fact the argument for a cost-basis deduction from the earnings in question is opposed to the decisions of this Court in *Van Every v. Commissioner,* 108 F. (2d) 650; *Boland v. Commissioner,* 118 F. (2d) 622; and *Somerville v. Commissioner,* 123 F. (2d) 975. This last cited case is typical. There the taxpayer entered into a property settlement with his wife in anticipation of divorce wherein it was agreed that the husband should pay his wife half of his earnings for the next two years. Notwithstanding the fact that he paid one-half thereof to the wife, this Court held that he was taxable on his entire earnings for those years.

The taxpayer has attempted to distinguish these decisions on the ground that they involved income earned after the property settlement. (Br. 14.) As previously noted, however, the effectiveness of such agreements to convert community property into separate property operates equally as well on past earnings as on future earnings. The fact that the agreement here operated on past earnings not received while the one involved in the *Somerville* case operated on future earnings not received is a distinction without significance. If the wife's interest in the community were that of a commercial partner, as the taxpayer seems to contend (Br. 13, 19, 25), her right to a half of all future earnings of the husband would certainly be a valuable property right. Hence it could be plausibly contended that the payments made to the wife in the *Somerville* case represented the *cost* of acquiring that property from the wife so that the husband should be entitled to deduct it as the *cost* of securing his earnings as separate property. Despite the superficial plausibility of this line of argument the fact remains that this Court squarely held in that case that the husband was taxable in full on the earnings that he received as his separate property. So here also the taxpayer is entitled to no deduction on account of the property transferred to the wife, for the reason that such expenditure does not represent the cost of anything acquired from the wife.

The basis and the only basis on which the taxpayer asserts the applicability of Sections 111 and 113 of the Revenue Act of 1934, governing capital transactions, is the theory that "In effect appellant [taxpayer] purchased his wife's one-half interest in said fee accounts receivable". (Br. 21, 44.) That is the starting point of his argument for a cost basis foi the portion of the earnings in question and the point at which the argument collapses.

In *Commissioner v. Larson,* decided October 21, 1942 (1942 Prentice Hall, par. 62,998), this Court very recently held that after dissolution of the community by the husband's death the taxability of income received during the administration of his estate was to be determined by reference to the substance of the situation, *i. e.,* who received and controlled such income. There the estate was held taxable in full on the income so received notwithstanding the wife's community interest therein. So here with respect to income received after dissolution of the community must regard be had for the substance of the situation in determining the tax liability.

As seen hereinbefore the husband was entitled prior to the property settlement to enjoy all the *substantial* attributes of ownership to his entire earnings including the right to spend them as he chose. It is perfectly clear that the taxpayer did not transfer any property to the wife as the cost of purchasing any technical property interest she had in his community earnings prior to their receipt and prior to the settlement. Such property rights could not have been purchased from the wife by a third party and would have been of no value to the husband, for without them he could spend these earnings as he pleased. The findings of the District Court that the value of the wife's interest in the community property was one-half thereof [R. 54] and that the cost to her of her interest in the community property was one-half the cost thereof [R. 57] were prepared by the taxpayer through a procedural accident [R. 51] and objected to by the prevailing party. [R. 131-143.] To the extent that they suggest that a wife's community interest in her husband's earnings is to be valued as a commercial partner's 50 per cent interest these findings are misleading. Since they are unsupported by the evidence in the record [see R. 102-105, 133-134] and opposed to the actual decision in the case they are entitled to no weight.

The realities of the situation are that apart from the impending divorce the wife's property in the husband's community earnings not yet received was a technical interest only, of no value to him. He transferred valuable property to her under the settlement agreement, not as the purchase price or the cost of this technical present interest she had in his community earnings, but as the satisfaction of the claim she would have had on the dissolution of the marriage by divorce. Just as the law in non-community property jurisdictions variously provides for a claim by the wife against the husband on dissolution of marriage so in California the wife on divorce for the husband's fault has a claim for one-half the community property (California Civil Code, Section 146) and in addition to an allowance for her future support if warranted by the parties' circumstances (California Civil Code, Sections 139, 142). Therefore in the property settlement agreement the taxpayer did not transfer property as the purchase price for something he did not then possess but rather as the price of settling claims which the wife could assert only in connection with the dissolution of the marriage.

This is made clear by the provision in the settlement agreement that the property transferred by the husband should be "* * * in lieu of all other compensation or claims of any kind * * *" the wife had against him. [R. 19.] These included her claim to one-half the community property on dissolution of the marriage, her claim to support, maintenance or alimony for the rest of her life, her claim to administration of his estate, to a probate homestead, to a family allowance and to inheritance in case he should predecease her in marriage. [R. 136-137.] If, as the taxpayer contends, the property settlement was a sale then all these claims would have to be valued in order to ascertain the portion of his cost allocable to the earnings in question. The failure of the taxpayer to introduce evidence respecting the value of these claims means that he has failed to establish the cost basis for the earnings in question, thus requiring the conclusion that he realized by the settlement agreement income in at least the amount determined by the Commissioner. This argument was developed in the defendant's motion for additional findings in the District Court. [R. 136.]

If the case is not to be resolved against the taxpayer on this basis it is because, contrary to his contention, the settlement agreement was not a sale. The District Court found that it was not a sale. [R. 53-54.] Actually, in that agreement the taxpayer purchased, not capital items, but freedom from marriage-related claims of the wife. In other words, the settlement was like one in any other state—the price of divorce. Whether that price be described as alimony or as a property settlement is immaterial. To the wife an award received by virtue of the divorce or a voluntary settlement preceding divorce substitutes for the husband's support. To the husband the substance of the transaction is an expenditure to free his earnings from the wife's claim to support. Hence the expenditure as an incident to the dissolution of marriage is a personal one to the husband and as such is not deductible. To argue that the property transferred by the taxpayer was the price paid for a portion of his uncollected earnings is to disregard the fact that prior to the settlement agreement he had the right to collect these accounts receivable and spend the proceeds for anything he wished. The only thing of value the wife had relating to these earnings was a claim in connection with the approaching divorce.

It must be recognized that the property transferred by the husband was the cost of dissolution of the marriage which resulted in simply freeing his earnings from a prospective claim by the wife, not in the acquisition of a capital item having a cost basis. Hence it is clear that a capital transaction was not involved so the case does not fall under Sections 111 and 113 of the Revenue Act of 1934. As stated by the Board of Tax Appeals in a similar case, *Crosby v. Commissioner,* 46 B. T. A. 323, 331:

> The right received by the petitioner [taxpayer] was one to receive ordinary earnings, and not property acquired through capital expenditure.

The collection by the taxpayer of his previous earnings did not involve the sale or other disposition by the taxpayer of any property for which he had a cost basis. He simply collected his earnings as such and they are taxable to him in full as his separate property.

The soundness of the above analysis can be demonstrated by considering what the taxpayer's position would be if, in the property settlement, he had transferred to his wife all the community property save the accounts receivable. Such a transfer might result if the wife drove a hard bargain. Could it be argued that the taxpayer's uncollected earnings had a cost basis equal to the property transferred so that a deductible loss would have been realized on their collection? Clearly the property transferred could not be so treated for it would represent, not the cost of the earnings, but the cost of dissolution of the marriage.

It may be observed that since the wife's community property interest in his earnings has no cost basis in the husband's hands and since he has never received anything by reason of his possession of this interest no question arises as to whether there has been a sale or other disposition thereof either by virtue of the settlement agreement or collection of the accounts receivable. The case of *Commissioner v. Mesta,* 123 F. (2d) 986 (C. C. A. 3d), relied on by the taxpayer (Br. 31, 35-38) is in no way inconsistent with this conclusion. There it was held the husband's transfer of stock to his wife under a settlement agreement preceding divorce constituted a "disposition" of that property within the meaning of Section 111(a) of the Revenue Act of 1934, rendering him taxable on the difference between the market value at the time of transfer and the cost. It is not suggested by the opinion in that case that the transfer gave the taxpayer a cost basis for the stock The stocks conceded cost basis was the sum the taxpayer had paid for it on its sale to him prior to the transfer of this stock to his wife under the settlement agreement. In the instant case it is admitted that prior to the settlement agreement there was no cost basis for the earnings. Hence the *Mesta* case is inapposite. In fact its characterization of a transfer of property under a settlement agreement as a "disposition" rather than a "sale" is opposed to the sale theory on which the taxpayer sought to establish a cost basis for the earnings in question.

Inasmuch as the husband transferred property in a settlement preceding divorce rather than as a part of a capital transaction he has no cost basis for the earnings in question and they are taxable to him in full.

Conclusion.

The decision of the District Court was correct and should therefore be affirmed.

Respectfully submitted,

SAMUEL O. CLARK, JR.,
Assistant Attorney General,

SEWALL KEY,
HELEN R. CARLOSS,
WILLARD H. PEDRICK,
Special Assistants to the Attorney General.

LEO V. SILVERSTEIN,
United States Attorney,

E. H. MITCHELL,
Assistant United States Attorney.

November, 1942.